



Business Consulting Services

Economic Growth Officers Training Workshop

Module 3: Financial Sector



Agenda for Financial Sector

- Are financial sector projects still relevant to USAID ?
- What has been our approach to financial sector assistance ?
- Where have we succeeded; where have we failed ?
- What is an integrated approach?
- How do we address non-tradable debt ?
- How do we address tradable debt, equities, and derivatives ?
- What are some promising integrated approaches ?

Are Financial Sector Projects Still Relevant ?

- Growth cannot occur without financial sector development
- A mature financial sector creates sustainability
- The financial sector is still plagued in many countries by:
 - Weak institutions
 - Inefficient allocation of capital
 - High transaction costs
 - Low activity
- USAID is well positioned to help in these areas if we understand lessons learned

What Has Been Our Approach ?

- Addressing banking and capital markets separately
- Rarely focusing on other non-bank financial intermediaries
- Focusing on:
 - Regulatory/Supervisory Infrastructure
 - Systems
 - Market development
 - Institutional development (multi-laterals)
- Infrastructure=Volume; “If you build it; they will come”
- Creating wide ownership will create market discipline

Where Have We Succeeded ?

- USAID has succeeded in achieving many of its outputs and intermediate outcomes:
 - Increasing access to banking services and consumer credit
 - Increasing MSME credit
 - Building systems infrastructure
 - Improving regulatory environment
 - Improving supervisory and regulatory capacity

Where Have We Not Succeeded ?

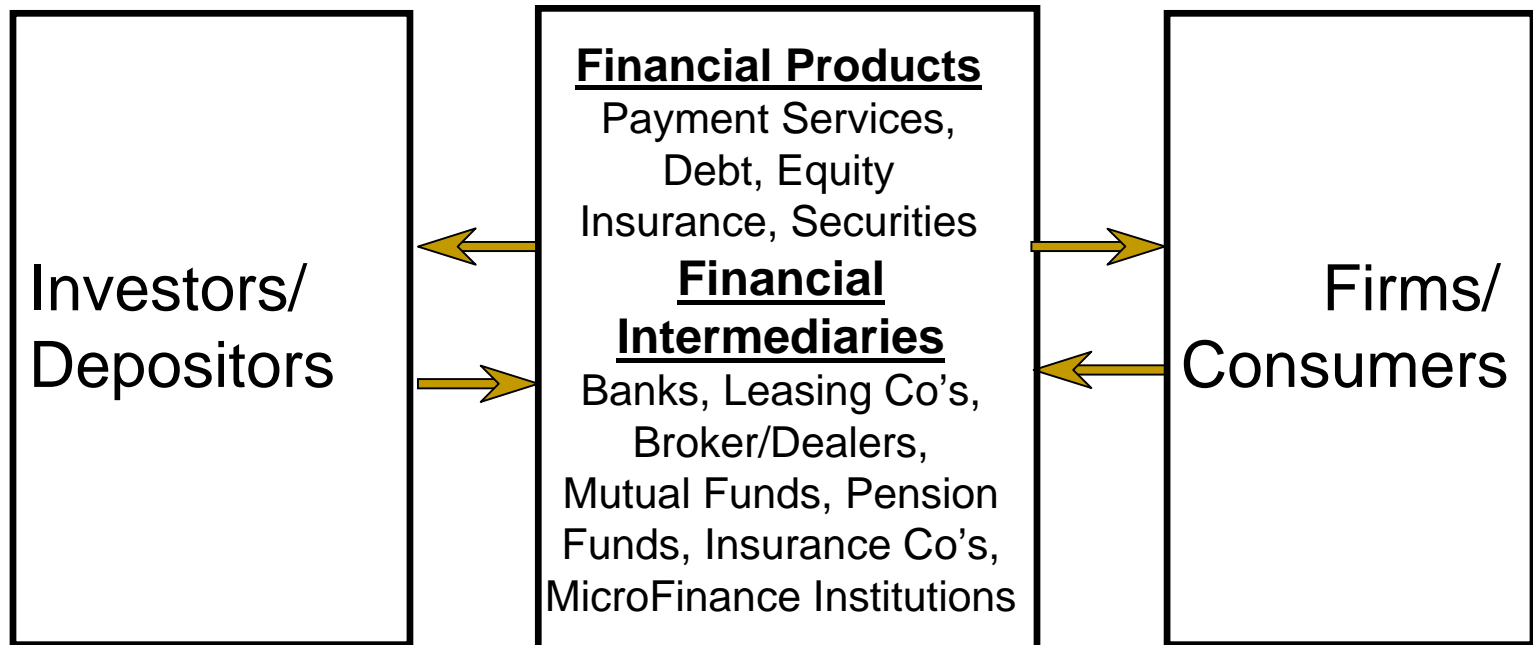
- But often failed to achieve our desired final outcomes:
 - Developing markets from scratch
 - Generating liquidity
 - Creating measurably better allocation of capital
 - Reducing transaction costs
 - Reducing volatility and risk
 - Creating market discipline for large enterprise

What Have We Learned ?

- Creating a market is not sufficient
- Market distorting activities are sometimes necessary, but ultimately may have limited long-term impact
- Capital markets development is not a leading edge reform
- We must understand market failure across the sector
- Reforms must be targeted to the right level of development
- *We must take an integrated approach and target more than just building markets from the outside*

What is An Integrated Approach ?

- Examining and targeting all stakeholders and institutions



Market Facilitators: Central Banks, Regulators, Credit Bureaus, Professional Services Providers, Stock Markets, Depositories

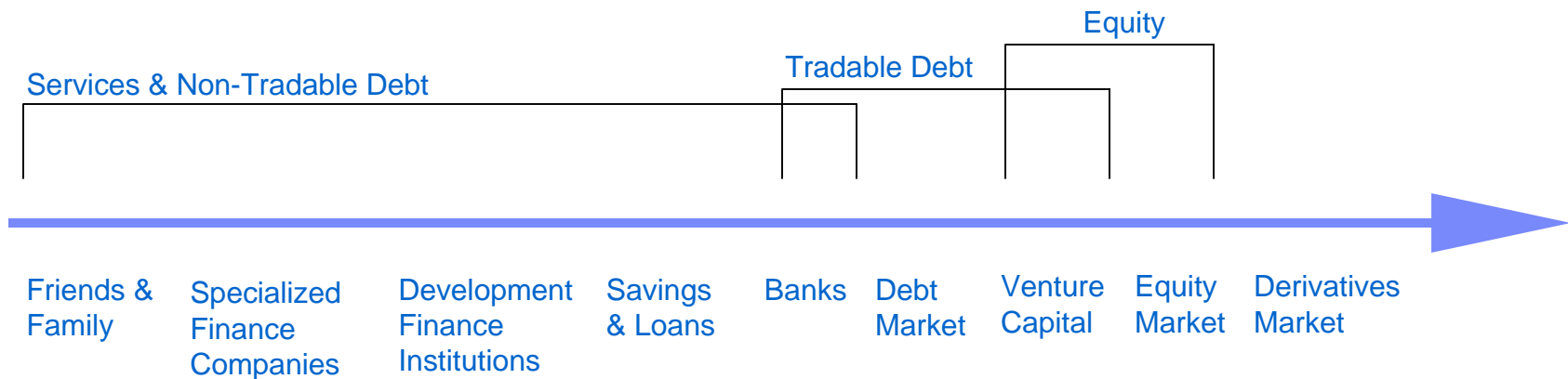
What is An Integrated Approach ?

- Identifying market failures where they exist

Area	Market Failure	Intervention
Legal structure	Banking, securities, pension law inadequate, courts weak	Legal analysis, drafting, assistance to commercial courts and judges
Regulatory/supervisory Capacity	Regulators not effective, regulations poor	Organizational development, training, regulation development
Information asymmetry	Financial reporting weak and poorly disseminated, little “watch dog” journalism	Accounting reform, disclosure, credit bureaus
Corporate Governance	Investor interests not protected, poor management in private sector	Advocacy, business dialogue, standards development, legal reform
Intermediation capacity	Banks, brokers, investment bankers, pension managers not effective	Training, tool development, CFA training, credit training, bank association development
Economic activity low; interest low	No “quality exists”, no investment or comfort in markets	Priming the pump, making mortgages and securitizing them, competitiveness approaches

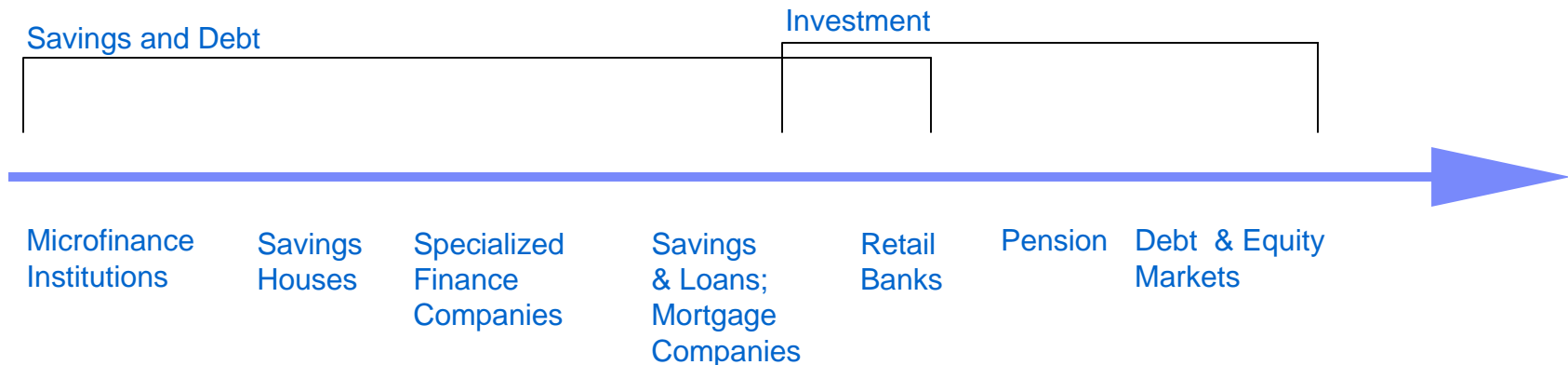
What is An Integrated Approach ?

- Sequencing assistance based on the continuum of financial services for Businesses



What is An Integrated Approach ?

- Sequencing assistance based on the continuum of financial services for Individuals



Why Does An Integrated Approach Work ?

- Tracks the transaction from depositor/investor to enterprise/consumer
- Identifies the full range of market failures across the sector
- Looks at linkages to corporate governance, LIR, and market development
- Sees the continuum between:
 - Banks and other service & debt providers
 - Financial markets
 - Non-bank financial intermediaries
- Acknowledges creative “pump priming” is needed in many markets
- Accepts limits on when financial sector projects make sense

What Does a Functioning Financial Sector Look Like?

- Strong Regulatory and Supervisory Framework and an Effective Independent Regulator
- Strong legal system (property rights and contracts)
- Broad Disclosure and Dissemination of Information
- Transactional Efficiency
- Role as Intermediary is working
- Skilled bankers
- Lack of Directed Lending (by State)
- Competition
- High liquidity
- Diverse products to allow for risk diversification and to increase access
- Capable self regulatory organizations (SROs) including exchanges, depositories, industry associations and others
- Predictable clearing and settlement of transactions

Who Sets The Standards?

BANKING

- Basle Supervisory Committee
 - Risk Management Framework
- IMF
 - Establishes Credit Conditions
- National Central Banks
 - Set National Monetary Policy
 - Provide regulation and oversight of financial institutions
 - Lender of last resort
- U.S Federal Reserve
 - Provides advice to commissions around the world

FINANCIAL MARKETS

- International Organization of Securities Commissions (IOSCO)
 - Legislative and Regulatory Framework
- International Securities Services Association (ISSA), G30
 - Clearing, settlement and depository functions
- International Federation of Stock Exchanges (FIBV)
 - Vision for future development, trading standards
- U.S Securities and Exchange Commission (SEC)
 - Provides advice to commissions around the world

These Standards Drive How Investors and the International Community will View a Market

What Are the Global Trends?

BANKING

- Liberalization of cross border money and investment flows
- Increased insolvencies and contagion effect of bank failure
- Universal Banking
- Technology-Based Payment Systems
- Risk Management Modeling Sophistication and Risk Based Supervision
- Growth of Formal, Non-Traditional Financial Institutions

FINANCIAL MARKETS

- Liberalization of cross border investment flows
- Consolidation of stock exchanges (Nextel, etc.)
- Consolidation of financial services firms
- Expansion of financial instruments (securitization, derivatives)
- Harmonization of disclosure (GAAP, IAS requirements)
- Active corporate governance

Where can USAID Help: Challenges Faced by Developing Markets

- Insolvency and the contagion effect; capital flight
- Weak regulatory, transparency and enforcement frameworks;
- Sectors controlled by State-owned banks and disincentives for public companies
- Weak disclosure and little information dissemination
- Low liquidity and few products; high transaction costs
- Lack of competition; small markets and small companies; low volumes of financial transactions
- Uneven access; dominance of private transactions
- New products and services posing new types of risk;
- New technologies posing new types of risk
- Sustainability of stock exchanges and brokers uncertain

Why Should USAID be Involved?

- Ensure financial self-sufficiency for emerging economies (reduce dependency on international financing, strengthen NBFIs)
- Enable increase in domestic consumption (mortgage, auto loans) and assist in developing new financial products
- Create conditions for pension reform – availability of non-government investment products
- Drive reform of business environment: corporate governance, transparency, anticorruption, insurance
- Assist in optimal regional integration (especially when asymmetry of power among partners)
- Help update regulator capabilities
- Coordinate with other donors (IFC, EBRD) for direct financing of capital

How and When Should USAID be Involved?

- USAID should support the development of infrastructure and markets-- but should avoid supporting individual institutions (except for “infrastructure” institutions)
 - USAID is most effective assisting regulators and supervisors and in helping build targeted markets
 - Attempts to develop individual financial institutions have generally been disappointing
- Banking projects must be designed tightly, with clear goals, and should not include too wide a range of activities.
 - Missteps in banking reform can have a devastating impact on an economy;
 - Other donor initiatives must be considered in designing interventions.

Why Not Let the Private Sector Develop the Financial Markets?

- Asymmetry of knowledge and market power among players (financial services companies, government agencies, etc.)
- Gravity of risks associated with failures (e.g. pyramid schemes in Albania)
- CDIE argues that “capital markets developed by the private sector alone will not produce the most satisfactory development result” in two main areas:
 - Protection of investors from firms
 - Protection of investors and firms from stock market intermediaries

- CDIE USAID, “Efficient Capital Markets: A Key to Development” Program and Operations Assessment Report No. 26, November 2000, p. 16.



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Banks: How Do We Address Services & “Non-Tradable” Debt?

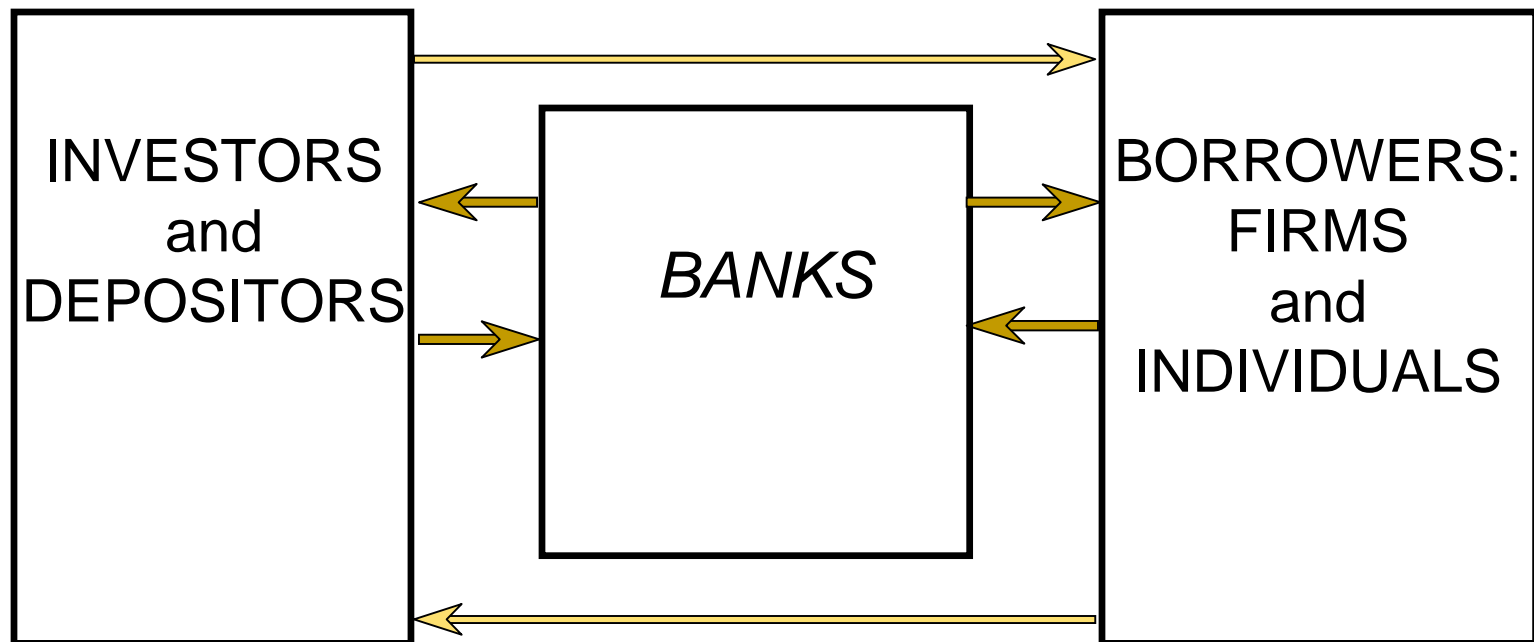
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Why Are Banks Important?

Functioning financial institutions have three primary functions:

- Participating in the payment system
- Collecting money to lend
- Lending money



What Are the Range of Banking Institutions?

- Traditional banking institutions
 - Commercial Banks
 - Thrifts
- Non-traditional financial institutions
 - Finance Companies
 - Development Institutions
- Government Lending Agencies
 - Specialized Financing Institutions (Agriculture, Housing, e.g.)
 - Credit Guarantors
- Intermediary Financial Institutions
 - Wholesale banks
 - Deposit Insurance Corporations

What Is the Goal of Banking Reform?

- The Primary Goal of Banking Reform Activities are to Ensure a Sound Banking Sector to:
 - Reduce risk for investors, depositors and borrowers
 - Provide transparency
 - Improve transactional efficiency
 - Increase access to financial services for under-served markets

Three Primary Forms of Donor Assistance

- Infrastructure Level
- Market Level
- Institutional Level

Examples of Primary Forms of Donor Assistance

Example 1: Institutional Reform – S.E. Asia

- Institutional Restructuring
- Good Bank / Bad Bank
- Recapitalization
- Cooperation of IMF, World Bank, Asian Development Bank

Examples of Primary Forms of Donor Assistance

Example 2: Market Development - Armenia

- On-Lend Program for Small and Medium Enterprise
- Direct Lending Program for Micro-enterprises
- Enterprise support activities to prepare potential borrowers
- Bank supervision strengthening program running concurrently
- Cooperation of WB/EBRD/UNDP, others

Examples of Primary Forms of Donor Assistance

Example 3: Infrastructure Reform - Bulgaria

- Bank supervision strengthening
- Privatization
- Asset Management/Disposition
- Deposit insurance
- Cooperation of WB/IMF, others



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Financial Markets: How Do We Address Tradable Debt and Equity?

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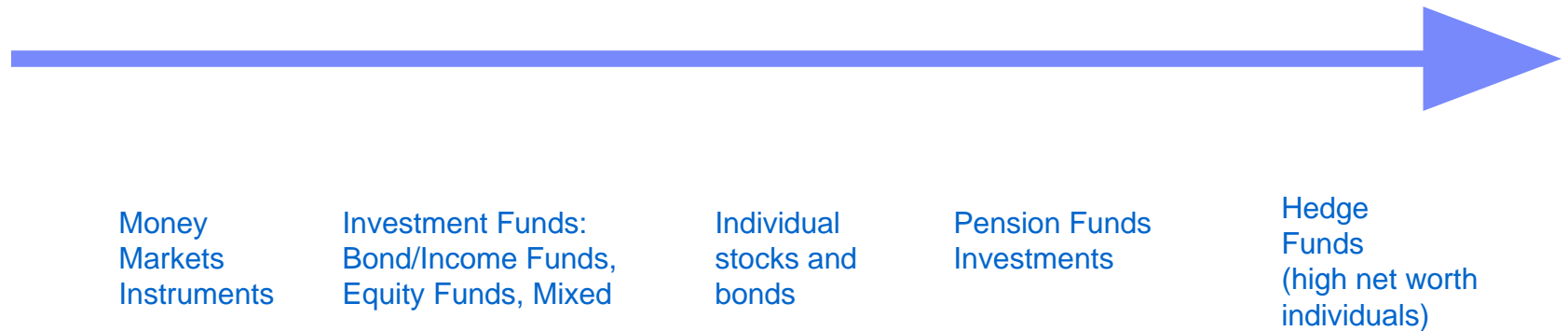
Continuum of Financial Services for Businesses

Tradable Debt and Equity

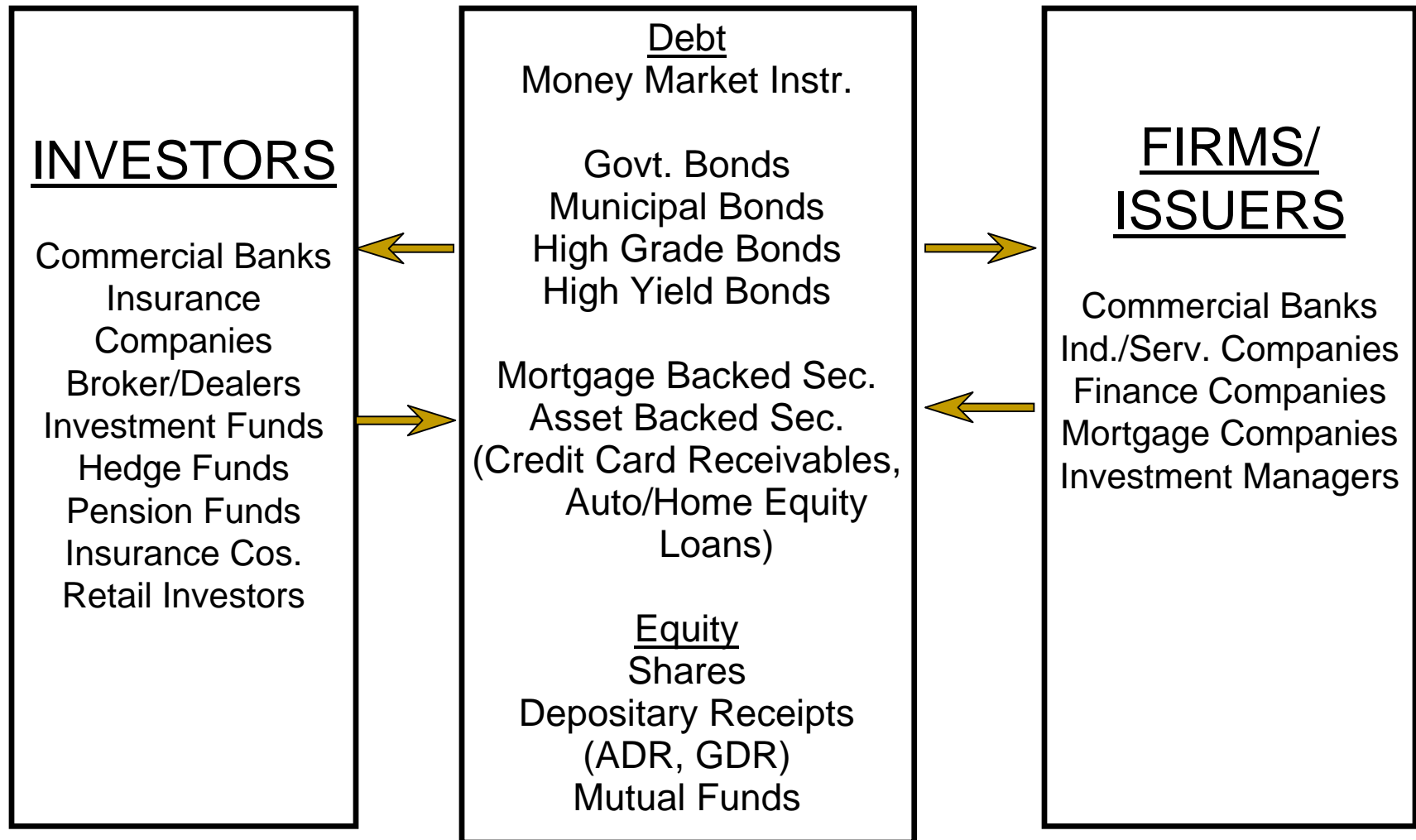


Continuum of Financial Services for Individuals

Tradable Debt and Equity



Fin. Markets: Investors, Products, Issuers



Markets: Money and Capital Markets

Financial Markets are composed of:

- Money Markets: markets for debt securities that pay off in the short term (usually less than one year)
 - Loosely connected dealer markets (dealers buy and sell instruments for their own inventory)
 - Core of money markets: large banks, govt. securities dealers, commercial paper dealers, money brokers

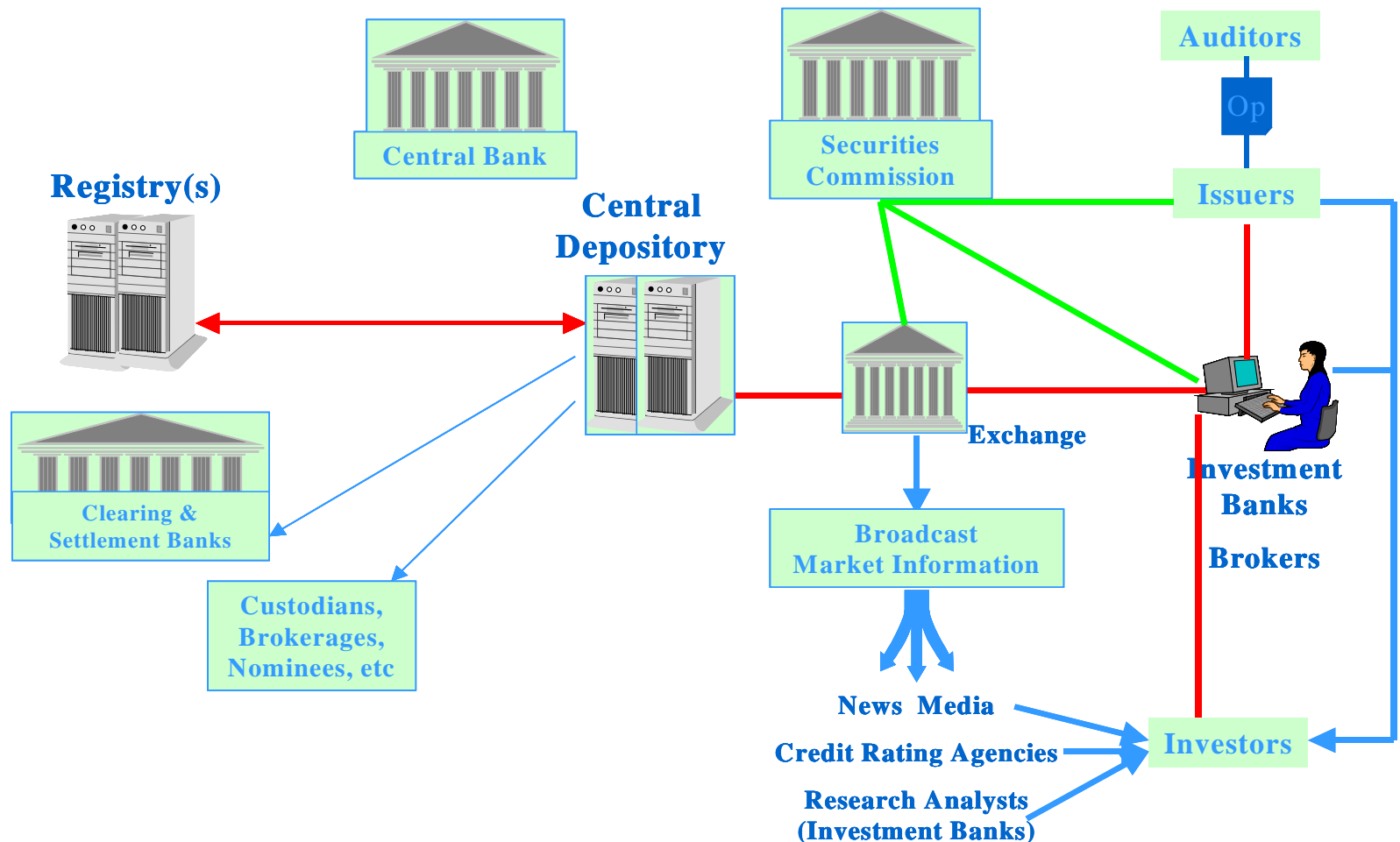
- Capital Markets: markets for long-term debt and for equity shares

Primary and Secondary Markets

- Primary Market: initial sale of newly issued securities
 - Underwriting syndicate, Registration of issue
 - Public offering vs. Private placement

- Secondary Markets: trading of securities after their original sale
 - Dealer markets (most debt securities) – over-the-counter (OTC) market
 - Exchange markets

Exchange-Based Capital Market



Components of Financial Market Reform

- **Legislation**
 - Objective: build a strong environment for enforcement of contracts and property rights
 - Key elements: empower independent financial/securities regulators, clarify roles of multiple regulators, train the judiciary
- **Support to Regulatory Institutions**
 - Objective: build capacity to protect investors
 - Key points: building capacity by division--enforcement, market regulation, corporation finance, policy
- **Capital Markets Infrastructure**
 - Objective: reduce transaction costs and increase investor protection
 - Key points: building trading and clearance and settlement systems and enhancing SRO procedures

Components of Financial Market Reform

- Assistance to Non-Bank-Financial-Intermediaries
 - Objective: professionalize NBFIs community; raise skill levels
 - Key points: NBFIs standards and certification, awareness and skills training, focused assistance for pilot transactions
- Corporate governance
 - Accounting standards
 - Judicial reform to improve enforcement
 - Skills building with managers
 - Work with all parties to establish a “coalition for better business”
- Other assistance:
 - Public education/participation
 - Assistance to companies issuing securities

Current Experience: Three Examples

- Financial Institutions Reform and Expansion Phases I and II (FIRE I and II) in India
- Integrated approaches involving capital markets, mortgages, corporate bonds, pension reform, insurance reform in Bulgaria and Kazakhstan
- Plan for building a fixed income exchange in the Philippines

Conclusions

- Financial market development promotes growth
- Corporate Governance to build a “coalition for better business” is an increasing focus
- Donors have a role to help correct market failures--markets alone do not achieve adequate investor protection
- Financial market reform is not a leading edge reform -- it should be addressed in an integrated approach with other reforms



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What Are Some Promising Integrated Approaches?

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What Are Some Promising Approaches ?

- Integrated financial sector reform in Macedonia
 - Integrating banking, capital markets, insurance and other assistance
- Building Integrated Financial Market Regulators
 - Addresses convergence of products and institutions
- Creating liquidity through NBFIs assistance in Armenia
 - Priming of the pump in a weak economy
- Regional approaches to capital market development
 - South Eastern Europe Regional Network (SEER) in the Balkans and Technology, Media, Telecommunications (TMT) in the Gulf countries – expanding markets to achieve critical mass

What Are Some Promising Approaches ?

- Market creation through new product development
 - Rural bank in Kosovo, mortgages in Serbia – demonstration effect
- Creating a financial services cluster (and sub-clusters) using a competitiveness framework in Bosnia